TABULA

Is it time to invest in the Middle East?

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For investors who are reassessing their emerging market (EM) fixed income investments, EM sovereign bonds can provide an excellent opportunity to establish defensive positioning within their portfolios. Regional exposures could offer a tactical source of income and return diversification outside of more traditional asset class coverage. In this article, we explore which specific EM region may provide the optimal mix of high income and low volatility returns.

Not all EM sovereign bonds behave alike

With recession fears and continued economic uncertainty remaining a predominant global concern, investors may now find it an auspicious time to reassess asset allocation decisions with a view to increase diversification across regions and instrument types.

Historically, bond investors allocating to pooled funds looked to different asset class exposures for top-down diversification. Today however, investors are able to diversify on the basis of geography as well. This level of granularity offers an opportunity to benefit from the investment performance of regions which are more resilient to rising oil prices and heightened inflationary pressures. Regional Emerging Market (EM) sovereign bond exposures can offer a tactical source of income and return diversification outside of more traditional asset class coverage.

In 2022, investors were faced with elevated inflation, tighter monetary conditions, and a resulting strong US dollar. Typically, a strong US dollar poses negative pressures on EM economies who rely on the trade of goods linked to the currency, and in many cases issue US dollar denominated debt that make US dollar interest payments to investors. EM sovereign ratings faced the second-highest number of downgrades in 2022 partly due to risks heightened by persistent supply chain issues and the impact of the war in Ukraine[1]. EM sovereign debt[2] exhibited double digit negative returns of -18% total return[3] in 2022, yet EM sovereign fundamentals have not deteriorated equally across the different regions[4]. The correction in bond yields provide relative value opportunities for investors seeking the right entry point into the asset class[5].

Regional exposures within EM bonds

Emerging market bonds, when split by region, can provide a selection of different opportunity sets with varying risk profiles, which investors can strategically capitalise on to manage the yield and total return potential of portfolios. Considering regional and broad EM sovereign bond indices (see table 1), three regions in particular have exhibited a positive Sharpe ratio[6]. The Middle East[7] demonstrated the highest excess returns to volatility of the four regions[8]. A combination of positive double digit total returns and low single digit volatility sets the Middle East region apart from the other emerging market regions over the period.

Table 1 | Regional and Broad EM Sovereign Bond Indices (USD)

	Total return since index inception	Volatility	Sharpe
Asia	4.52%	3.99%	0.20
Middle East	15.43%	5.88%	0.45
Latin America	-12.41%	9.38%	-0.25
Africa	8.79%	17.26%	0.09
EM	-2.82%	7.18%	-0.07

Past performance is not a reliable indicator of future returns. Source: ICE index data from 30 June 2017 to 31 December 2022. ICE BofA Asian Dollar Government Index representing Asia, ICE Gulf Cooperation Council Government Bond ex-144a Index representing the Middle East, ICE BofA Latin America External Debt Sovereign Index representing Latin America, ICE XAFL0006 Custom Index representing Africa and the J.P. Morgan ESG EMBI Global Diversified Index representing broad Emerging markets sovereign and quasi-sovereign bonds. A custom index was created on ICE for analysis purposes in the case when a regional index was not readily available.

[1]Source: Fitch report dated 10 October 2022, "2022 Is Second-Worst Year for EM Sovereign Downgrades",
[2]Considering the J.P. Morgan ESG EMBI Global Diversified Index
[3]Source: Bloomberg, J.P. Morgan ESG EMBI Global Diversified Index (EMBIGD) to 30 November 2022
[4]Source: Considering debt to GDP ratios - emerging market countries,
[5]Source: Yield to maturity of the J.P. Morgan ESG EMBI Global Diversified Index, as of 30 November 2022 versus 31 December 2021.
[6]Source: ICE indices, using common since inception data to 31 December 2022. Emerging Market government bond exposures considering the following indices: ICE BofA Asian Dollar Government Index representing Asia, ICE Gulf Cooperation Council Government Bond ex-144a Index representing the Middle East, ICE BofA Latin America External Debt Sovereign Index representing Latin America, ICE XAFL0006 custom index representing Africa and the J.P. Morgan EMBI Global Diversified index representing broad US dollar emerging market fixed and floating-rate debt issued by sovereign and quasi-sovereign entities. A custom index was created on ICE indices for analysis purposes in the case when a regional index was not readily available.
[7]Source: Middle East as represented by the ICE index in table 1, data from 30 June 2017 to 31 December 2022.
[8]Source: Period considers common since inception of the indices, 30 June 2017 to 31 December 2022.

In 2022 the Middle East, and specifically sovereign bonds issued by the Gulf Cooperation Council (GCC), outperformed broad Emerging market sovereign bond exposures[9] as well as other EM regions. GCC sovereign bonds have also outperformed broad Emerging market sovereign bonds in recent years, which have been marked with unprecedented levels of volatility and economic uncertainty (see table 2).

Table 2 | Historical Total Returns: Regional and Broad EM Sovereign Bond Indices

2022	2021	2020	2019	2018
Middle East -11.3%	**Middle East** 1.1%	**Africa** 9.0%	**Africa** 20.8%	**Middle East** 0.2%
Asia -13.9%	**Asia** 0.1%	**Middle East** 8.8%	**Middle East** 16.5%	**Asia** -0.9%
Africa -15.5%	**Africa** -1.5%	**Asia** 6.0%	**Broad EM** 15.0%	**Broad EM** -4.3%
Latin America -16.0%	**Broad EM** -1.8%	**Broad EM** 5.3%	**Asia** 13.1%	**Latin America** -7.4%
Broad EM -17.8%	**Latin America** -5.3%	**Latin America** 3.3%	**Latin America** 10.3%	**Africa** -7.4%

Past performance is not a reliable indicator of future returns. Source: ICE index data from 1 January 2018 to 30 December 2022. ICE BofA Asian Dollar Government Index representing Asia, ICE Gulf Cooperation Council Government Bond ex-144a Index representing the Middle East, ICE BofA Latin America External Debt Sovereign Index representing Latin America, ICE XAFL0006 Custom Index representing Africa and the J.P. Morgan ESG EMBI Global Diversified Index representing broad Emerging Markets sovereign and quasi-sovereign bonds. A custom index was created on ICE for analysis purposes in the case when a regional index was not readily available.

What dynamics make the GCC region interesting for investors?

The US dollar-denominated sovereign bond market in the Middle East region can include bonds issued by Egypt, Israel, Jordan, and the Gulf Cooperation Council Countries (GCC), which includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE)[10]. The GCC is an economic and political coalition of six Middle East countries, which among its objectives, was created to unify financial affairs. Most GCC countries benefit from investment grade credit ratings supported by low debt-to-GDP ratios[11] (see Table 3).

The GCC includes some of the highest growth economies globally supported by a combination of elevated oil and natural gas revenues and healthy investment plans aimed at diversifying sources of GDP growth across the region[12]. While the GCC has benefitted from recent higher oil prices, there are a number of substantial infrastructure projects underway aimed at developing non-hydrocarbon industries to expand the revenue streams and support the younger population. The move to more climate friendly industries may support the region in transitioning to a low carbon economy in the medium to long-term, and reduce the region's reliance on oil and gas for fiscal revenue. For

Table 3 | GCC Credit Fundamentals are Strong

	Saudi Arabia	UAE	Qatar	Oman	Bahrain	Kuwait
GDP (US$)	1,010 bn	504 bn	221 bn	109 bn	44 bn	184 bn
Debt outstanding (US$)	250 bn	155 bn	104 bn	49 bn	52 bn	13 bn
Debt to GDP ratio	0.25	0.31	0.47	0.46	1.18	0.07
Credit rating	A2	AA3	AA3	BB3	B1	A1
Population	36.4 mn	9.4 mn	2.7 mn	4.6 mn	1.5 mn	4.3 mn
GDP annual growth rate	7.6%	5.1%	3.4%	4.4%	3.4%	8.7%
2022 account balance (US$)	161.5 bn	74 bn	47 bn	6.7 bn	3.7 bn	53 bn
Sovereign wealth fund size (US$)	620 bn	709 bn	461 bn	17 bn	18 bn	708 bn

Source: Capital Economics, Statista, Bloomberg, Macrotrends, Tabula, as of December 2022.

[9] Middle East is represented by ICE Gulf Cooperation Council Government Bond ex-144a Index. Total return year to date to 30 November 2022.

[10] Source: Description as outlined by the GCC website: https://www.gcc-sg.org/en-us/AboutGCC/MemberStates/pages/Home.aspx

[11] Source: International Monetary Fund report www.imf.org report "Economic Prospects and Policy Challenges for the GCC Countries – 2021" and Fitch ratings report https://www.fitchratings.com/research/sovereigns/upward-trend-in-gcc-gre-debt-is-likely-over-medium-term-22-12-2021.

[12] Source: https://mea.gov.in/Portal/ForeignRelation/Gulf_Cooperation_Council_MEA_Website.pdf

example, the UAE was rated highly among GCC countries in the circular carbon economy index, which measures a countries progress towards achieving net zero-emissions[13].

Given the UAE's long term economic overhaul plan to diversify the economy, by 2030 the state will have made considerable progress towards implementing an impressive number of initiatives aimed at supporting the United Nations Sustainable Development Goals (SDGs) and economic growth for the region. For instance, the Abu Dhabi Transportation Mobility Management Strategy is expected to help cut transportation costs by 44 per cent, resulting in savings of up to US$245 million annually and generating US$5 billion in annual economic returns by 2030[14]. The Mohammed bin Rashid Al Maktoum Solar Park is one of the biggest concentrated solar parks globally and is estimated to raise the share of clean energy in Dubai's total power output to 25 percent by 2030 and 75 percent by 2050[15].

Saudi Arabia, the largest economy in the Middle East, has earmarked US$1 trillion investment into real estate and infrastructure projects over a ten-year period providing support for further growth[16]. S&P Global Ratings upgraded the outlook for Saudi Arabia from 'stable' to 'positive' in the first quarter of 2022 and it is estimated to have a growth rate of 2.8% in 2023[17].

Regional EM sovereign bond exposures can add value to portfolios

For investors reassessing their emerging market investments in 2023, regional EM sovereign bond exposures can offer a tactical source of income and return diversification outside of more traditional asset class coverage. When assessing historical performance metrics, sovereign bonds issued by GCC countries have exhibited a superior Sharpe ratio when compared to broad EM sovereign exposures, and can offer high income. The GCC region is undertaking numerous initiatives to diversify revenue streams away from oil and gas, placing a heavier emphasis on more climate friendly industries. As a result, regional EM sovereign bond exposures can play a significant role in building more defensive portfolios.

[13] Source: The circular carbon economy index measures how countries are managing progress toward circular carbon economy, 2022 rankings, website: https://cceindex.kapsarc.org/cceindex/ranking/cceindex
[14] Source: Plan details as outlined on the UAE website: https://u.ae/en/more/uae-future/2021-2030
[15] Source: Plan details as outlined on the UAE website: https://u.ae/en/more/uae-future/2021-2030
[16] Source: S&P Global Ratings, Saudi Arabia's Vision 2030, S&P outlook upgraded to "positive" March 2022.
[17] Source: "The economic context of Saudi Arabia" dated December 2022, https://www.lloydsbanktrade.com.

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